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SUBJECT: LEADING CHINESE ECONOMIST ON CHINA'S CHALLENGES

SUMMARY

¶1. (SBU) One of China's leading economists briefed China Mission Economic Officers on the country's economic challenges. Although he expressed concerns about income inequality, deflation, and the challenges of following through on economic reforms, his overall message was that the quality of leadership on economic matters warrants broad optimism. Participating Econoffs responded in particular with questions about China's ability to pursue income distribution and economic restructuring goals under the Eleventh Five-Year Plan (FYP). The researcher insisted that the FYP is a step in the right direction towards rebalancing growth and solving socioeconomic problems, including China's income disparity, aging population, resource inefficiency, and social instability. END SUMMARY.

BIO NOTE

¶2. (SBU) Justin Yifu Lin founded the China Center for Economic Research at Beijing University in 1994. Lin, considered one of China's leading economists, also advises the Central Government on economic policy. Lin earned his PhD in Economics from the University of Chicago in 1986.

CHALLENGES FOR CHINA'S ECONOMY

¶3. (SBU) At a mid-October briefing attended by Economic Officers from Beijing, Shanghai, Chengdu, Guangzhou, and AIT Taipei, Lin noted that the Eleventh FYP (2006-2010) is based on China's strong economic performance since reform and opening in 1978, particularly the strong growth of the past three years (10.0 percent in 2003, 10.1 percent in 2004, and 10.2 percent in 2005). He emphasized, however, that during the Eleventh FYP, China would need to overcome six significant challenges: 1) deflation, 2) low per capita income, 3) resource shortages, 4) income disparity, 5) an inadequate social safety net, and 6) the government's unfinished reform agenda.

THE THREAT OF DEFLATION

¶4. (SBU) Lin said that most Chinese economists are less concerned with inflation than they are with deflation. From 2003 to 2005, overheating in several energy-intensive sectors prevented deflation by artificially raising the prices of construction materials. In the wake of 2005-2006 investment growth rates above 25 percent, the Chinese Government is now taking action to slow things down and this brings with it a strong possibility of deflation. China's current low inflation rate of approximately 1 percent would be considered deflation in almost any other country, he said.

GROWING INCOME GAPS

¶5. (SBU) A longer-term concern is low per capita income, Lin stated. Most non-Chinese analysts fail to recognize that the country's per capita income remains very low at USD 1,730 per year, which amounts to only 4 percent of the U.S. average, he said. Further complicating matters, income disparity is growing, potentially fueling social instability. China's Gini coefficient is now 0.45, with urban income three times higher than rural incomes. (Note: The Gini coefficient measures income inequality in a society, with a measure of 0 equaling full equality and 1 equaling full inequality. The U.S. Census Bureau estimates the Gini coefficient in the U.S. in 2004 for money income to be 0.45. End Note.)

FACING SOCIAL CONCERNS

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¶6. (SBU) Lin said China has consumed a disproportionate amount of resources during its rapid economic growth. According to Lin's statistics, in 2004, China's GDP was only 4 percent of the global total, but the country consumed 12 percent of the world's energy and 15 percent of its fresh water. China must also face rapid aging: more than 12 percent of the population is over 60, and the social security fund is estimated to have a shortfall of RMB 300 billion to RMB 1 trillion (USD 37.5 billion to USD 125 billion).

THE GOVERNMENT'S UNFINISHED REFORM AGENDA

¶7. (SBU) Lin endorsed the Eleventh FYP as a means to address problems resulting from unfinished reforms, including non-performing loans, county-level government debt, and state-owned enterprises with poor performance. President Hu Jintao's emphasis on scientific development steers the government towards continuing to rely on economic development and reform to solve emerging problems but also recognizes that China needs to achieve balanced growth, especially when facing problems such as income inequality or resource inefficiency.

LIN'S OPTIMISTIC OUTLOOK

¶8. (SBU) Lin strongly intimated that the government will be able to resolve China's most pressing socioeconomic problems. According to Lin:

-- Deflation will not prevent the economy from maintaining robust growth of at least 8 percent per annum, as deflation would be caused by overinvestment in certain sectors rather than by a bursting bubble in those sectors.

--The Eleventh FYP's New Socialist Countryside initiative may unleash a significant pending demand and absorb existing excess capacities.

--State-owned enterprise (SOE) reforms will reduce the need for policy loans in the banking sector, and the entry of foreign banks will speed up banking reforms.

--The Chinese Government remains in firm control and social unrest is unlikely to grow beyond localized conflicts. FYP strategies on income distribution, addressing regional disparities, and promoting social development will alleviate social tensions in rural areas.

COMMENT: TOO OPTIMISTIC?

¶9. (SBU) China Mission Economic Officers attending the presentation believe Lin's assessment of China's policy prescriptions is overly optimistic. Lin's briefing perhaps reflected a common problem in Beijing where academics often are co-opted into the policy process and then feel compelled to defend those policies. We found it interesting, for example, that Lin took credit during the briefing for contributing to formulating the New Socialist Countryside policy and then proceeded to exude a degree of optimism about the policy that we believe is unfounded.

¶10. (SBU) During the briefing, Econoffs questioned Lin on a variety of topics, including: the impact of deflation on economic growth, funding fixed asset investment through retained earnings, the socioeconomic situation in the countryside, trade and services liberalization, reform of equities markets and securities firms, implementation of the FYP, and mergers and acquisitions regulations. Lin's answers on several topics sounded like Party-line talking points, particularly with regard to rural policy, financial reforms, and liberalization of trade and services -- all areas where we do not feel China's progress justifies Lin's rosy outlook.

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